

ANALYSIS OF ORIGINAL BILL

Author: Poochigian Analyst: Gloria McConnell Bill Number: AB 2335

Related Bills: See Legislative History Telephone: 845-4336 Introduced Date: 02/19/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Medical Savings Account Deduction

SUMMARY

Under this bill, for taxable years beginning on or after January 1, 1998, a deduction would be allowed for an individual's contributions to a California medical savings account (MSA), not to exceed a yet to be specified dollar amount. Interest and dividends accrued on a California MSA would not be taxable. Amounts deposited in a California MSA would be used for any medical needs not covered by insurance (unreimbursed medical needs), including (1) living expenses if the taxpayer has a loss of income related to a medical condition or (2) insurance premiums, if funds to pay those premiums have been held in the account for at least one year.

In addition, for each taxable year beginning on or after January 1, 1998, any amounts withdrawn from a California MSA by the taxpayer after the taxpayer reaches 59½ years of age would be included in the taxpayer's gross income in the year of withdrawal.

EFFECTIVE DATE

This bill would be effective upon enactment and the provisions would be operative for taxable years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

SB 38 (Stats. 96, Ch. 954).

PROGRAM HISTORY/BACKGROUND

Under SB 38, California conformed to the federal MSA law enacted in 1996. This California law applies only to those individuals allowed the deduction/exclusion under federal law and filing California returns.

Under the federal law, which began on January 1, 1997, and California law, which began for taxable years beginning on or after January 1, 1997, within

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___ X ___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director Date
Gerald H. Goldberg 3/17/98

Agency Secretary Date

By: Date

limits, contributions to a medical savings account (MSA) are deductible as an adjustment to gross income if made by an eligible individual or excludable from gross income if made by the employer of an eligible individual. Earnings on amounts in an MSA are not taxable prior to distribution, and distributions from an MSA for medical expenses, as defined, are not taxable. Withdrawals for other than allowed medical expenses are includible in the taxpayer's gross income, and the tax on that includible amount is increased by 15% (15% penalty).

MSAs are available to individuals covered under an employer-sponsored high deductible plan of a small employer and to self-employed individuals covered under a high deductible plan.

In general, the MSA deduction/exclusions are limited to a maximum of 750,000 taxpayers. Previously uninsured individuals are not taken into consideration in determining whether the cap is reached. After December 31, 2000, generally, no new contributions may be made to MSAs except for those who were participating in the pilot program. A phase-in schedule was established for purposes of maintaining the maximum 750,000 taxpayers. As of June 30, 1997, 525,000 MSAs could have been established under the phase-in. However, according to a September 12, 1997, IRS announcement, by that date 17,145 MSAs had been established. A press release from industry sources indicates 40,000 MSAs had been established.

SPECIFIC FINDINGS

Under current law, California conforms to the federal MSA law for those taxpayers who are part of the federal pilot program, including the nontaxability of earnings on amounts in an MSA. Withdrawals may be taxable and subject to "penalty" if the withdrawal is not used for medical expenses as defined.

Under this bill, interest and dividends accruing on a California MSA would not be taxable, but any amounts withdrawn by a taxpayer after reaching 59½ years of age would be taxable to the taxpayer.

Under current law, if the self-employed individual or an employee of a small-employer is covered by an employer-provided high deductible health plan, MSA contributions made by the employee are deductible by the employee or self-employed individual. MSA contributions made by an employer are deductible by the employer and cannot be included in the taxable income of the employee; however, an employee cannot have a deduction in the same year as the employer. In addition, any withdrawals for qualified medical expenses, as defined, are not taxable events. Medical expenses are those traditionally unreimbursed medical expenses taken as an itemized deduction and do not include insurance payments, except long-term care insurance; premiums for "COBRA"-type health care continuation coverage; or premiums for health care coverage while receiving unemployment. Withdrawals for non-medical expenses are subject to a 15% penalty. If an individual makes a withdrawal for non-medical purposes and is either 65, becomes disabled or dies, the 15% penalty does not apply.

Under this bill, if an individual contributes to a California MSA, a deduction would be allowed up to a yet to be specified amount. A California MSA would be an account that is held by a federal trustee described under the Internal Revenue

Code. Funds may be withdrawn by the taxpayer after the taxpayer reaches 59½ years of age, but would be taxable. Funds in an MSA could be used for unreimbursed medical needs, including living expenses if the taxpayer has a loss of income related to medical condition or insurance premiums if premiums were paid with funds that were in the account for at least one year. However, it is unclear whether the withdrawal for such medical purposes would be a taxable event.

Policy Considerations

According to the author's office, this bill was to provide Californians more flexibility to withdraw funds from their MSAs than current federal/state MSA laws allow. However, the author's staff may be reconsidering the original concept of this bill because, by not requiring compliance with all federal rules and allowing the funds to be used for other than what is allowed under federal law, taxpayers currently making MSA contributions who would seek to take advantage of this proposal run the risk of losing or eroding the beneficial federal tax treatment because this proposed California MSA law is more flexible.

Implementation Considerations

It is unclear whether the author intends for this bill to replace California's existing federal conformity provision (SB 455; Section 17024.5 (a)(1)(J)) or whether this bill would apply to taxpayers who establish a California MSA account separate and apart from the MSA established for federal tax purposes. Upon request of the author's staff, FTB staff is available to provide technical assistance. In clarifying the intent of this bill, the author's staff may give consideration to the following:

If this bill is intended to replace California's existing federal conformity provision and the taxpayer were to establish the MSA under current law to receive the federal treatment but withdraw funds as allowed under this bill, the taxpayer, at a minimum, would have to include the amount withdrawn in their gross income and pay the 15% penalty for federal purposes.

If this bill is intended to replace California's existing federal conformity provisions and taxpayers were to establish the MSA under this bill, unless the majority of all federal MSA provisions (e.g., the requirement for a high deductible health plan, the limitations on the amount of the deduction, definitions, etc.) were conformed to, taxpayers could not receive the federal deduction and other beneficial federal tax treatment, including the employer ability to contribute and not include the contribution in the employee's income.

If this bill is intended to provide a California MSA separate and apart from the current MSA laws (federal and California), the bill should, at a minimum, define "medical needs." As the bill is introduced, it is unclear that withdrawals for unreimbursed medical needs are excludable from tax. Also it is unclear as to the tax consequences, if any, when funds are withdrawn for other than unreimbursed medical needs. In addition, it is unclear as to the tax consequences, if any, if a person is over 59½ years of age and the funds are withdrawn for unreimbursed medical needs.

Additionally, the bill should provide that any deduction or exclusion from income provided under this California MSA law would be in lieu of any other deduction or exclusion for the same contribution or item of income allowed under other laws.

FISCAL IMPACT

Departmental Costs

The department's costs cannot be determined until the implementation considerations are resolved.

Tax Revenue Estimate

Because the percentage has yet to be specified, and there are no clear definition as to who would qualify for a California MSA, the revenue impact of this bill cannot be determined.

BOARD POSITION

Pending.